FOR AGENDA

EBS/08/124
Supplement 1

CONFIDENTIAL

November 17, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Assessment of the Risks to the Fund and the Fund's Liquidity Position**

The attached note, which assesses the risks to the Fund arising from the proposed Stand-By Arrangement for Iceland and its affects on the Fund's Liquidity position, is being issued as a supplement to the paper on Iceland's request for a Stand-By Arrangement (EBS/08/124, 11/15/08), which is tentatively scheduled for discussion on **Wednesday, November 19, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Iceland indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Ms. Bassett, FIN (ext. 34621) and Mr. Arvanitis, SPR (ext. 36054).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

Iceland—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Tessa van der Willigen

November 17, 2008

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Iceland and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.**[1] [2] The authorities are requesting a two-year SBA with access of SDR 1.4 billion (1,190 percent of quota). A front-loaded purchase of SDR 560 million (about 476 percent of quota) would be made available upon approval of the arrangement; this would be followed by eight quarterly purchases of SDR 105 million each. The last purchase is scheduled to take place in October 2010 (Table 1).

Table 1. Iceland: Proposed SBA—Access and Phasing

		Purchases		
			Percent of quota	
Availability	Date 1/	SDR mn	Annual	Cumulative
2008	November (Approval)	560.0	476.2	476.2
2009	February	105.0	89.3	565.5
	May	105.0	89.3	654.8
	August	105.0	89.3	744.0
	November	105.0	89.3	833.3
2010	February	105.0	89.3	922.6
	May	105.0	89.3	1,011.9
	August	105.0	89.3	1,101.2
	October	105.0	89.3	1,190.5
	Total	1,400.0	1,190.5	1,190.5

Source: Finance Department.

1/ Starting from February 2009, purchases will depend on the completion of a review.

[1] See *The Acting Chair's Summing Up of the Review of Access Policy Under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy* (BUFF/03/28, 3/5/03).

[2] The analysis in this supplement is based on information on Fund arrangements as of end-September 2008. Except where specifically noted, it does not take into account the effects of other arrangements that may be put forward for the consideration of the Board.

I. BACKGROUND

2. **Reflecting its prosperity and sound macroeconomic performance, Iceland has not borrowed from the Fund for over two decades.** The last time it used resources of the Fund was under the Compensatory Financing Facility (CFF) in 1982, on account of a temporary shortfall in fish and aluminum export earnings.[3] Iceland has had no outstanding obligations to the Fund since 1987.

3. **However, Iceland is currently facing a banking crisis of extraordinary proportions.** External debt ballooned in recent years, largely on account of borrowing by the banking sector. Bank borrowing rose by about US$55 billion during 2005–07, pushing total external debt to some 550 percent of GDP by end-2007 (Table 2).

Table 2. Iceland: External Debt, 2005–2008

		2005	2006	2007	2008 1/
		(In billions of U.S. dollars)			
Total External Debt		46.6	74.4	111.5	112.5
of which:	Public	2.5	3.5	3.8	16.8
	Private	44.1	70.9	107.7	95.7
	of which: banks	38.2	60.9	93.8	84.8
Adjustment (banks):		*(38.2)*	*(60.9)*	*(93.8)*	*(84.8)*
Adjusted External Debt 2/		8.4	13.5	17.7	27.7
		(In percent of GDP)			
Total External Debt		285.7	445.9	551.5	670.2
of which:	Public	15.0	20.9	18.8	99.9
	Private	270.7	424.9	532.6	570.3
	of which: banks	234.3	365.0	463.8	505.2
Adjustment (banks):		*(234.3)*	*(365.0)*	*(463.8)*	*(505.2)*
Adjusted External Debt 2/		51.4	80.9	87.7	165.0

Sources: Icelandic authorities and IMF staff estimates.

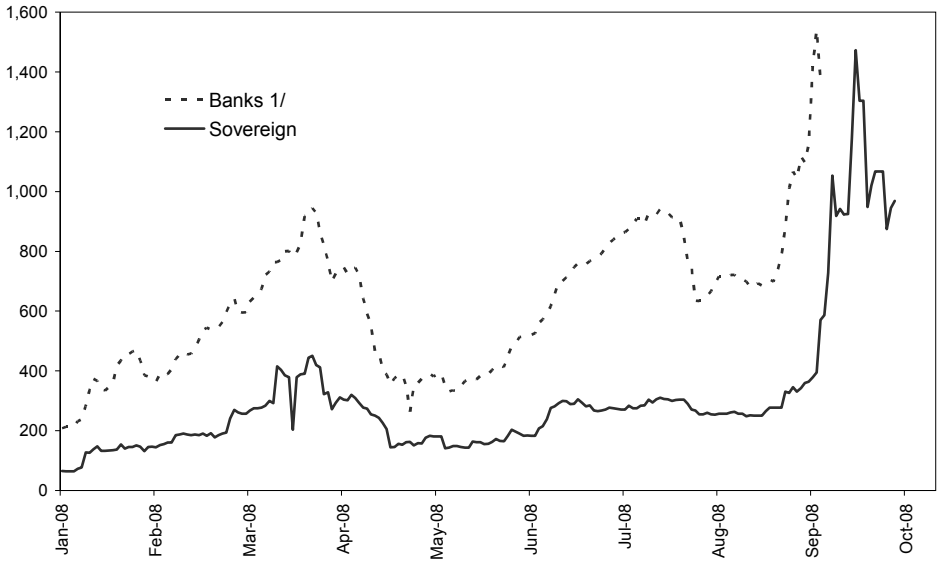
1/ Projected to end-2008.
2/ Sum of public and nonbank private external debt. Series used to assess external debt sustainability in the accompanying staff report (see EBS/08/124, 11/15/08, Attachment III).

4. **With the onset of global financial market turbulence in 2007, the large funding risks associated with Iceland's banking sector debt came to the fore.** CDS spreads on banks were very high since early 2008, reflecting growing market concerns about the banks'

[3] Iceland's purchase in 1982 under the CFF amounted to SDR 21.5 million and was fully repaid in December 1987. Prior to that, Iceland used Fund resources under the Oil Facility and the CFF in the 1970s, and made purchases under Stand-By Arrangements in the 1960s.

solvency (Figure 1). Sovereign spreads were significantly lower until September, when the government intervened the three largest banks, one after the other, to mitigate the costs of the crisis. Shortly thereafter, the government split each bank into an "old bank" and a "new bank." The former are to be liquidated, and creditors to be paid with the proceeds from the sale of the banks' assets. A tradable bond to be issued by the new banks to the old banks will also be used to compensate creditors.

Figure 1. Iceland—CDS Spreads for Sovereign and Three Largest Banks, 2008
(in basis points)



Source: Datastream.

1/ Simple average of CDS spreads of individual banks. Data through end-September, when the banks were intervened.

5. **Compared to recent exceptional access cases, Iceland's external debt–to–GDP ratio is very high, even after excluding the banks' external debt (Table 3)**.[4] [5] Reflecting

[4] The exceptional access cases used as comparators in this paper are those approved since this policy was put in place. The 2008 extended arrangement for Liberia also involved exceptional access. However, Liberia is excluded since this arrangement was different in that exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

[5] The proposed SBA assumes that the Icelandic authorities will make payments on the costs of compensating insured foreign depositors up to the statutory limit of the deposit insurance. Other liabilities, including external debt (projected to amount to about US$85 billion at end-2008) are envisaged to be extinguished through some combination of asset recovery (in excess of the amounts that will be used to cover insured deposits), a tradable bond issued by the new banks to the old banks, and the write-down of the value of the claims in bankruptcy. To avoid making explicit assumptions about the timing and modalities of this process, the external debt sustainability analysis in the accompanying staff report excludes banks' external liabilities from total external debt—see Attachment III—External Debt Sustainability Analysis and Fiscal Sustainability Analysis, in EBS/08/124.

Iceland's adherence to prudent fiscal policies, public external debt was very low (less than 20 percent of GDP in gross terms—and less than half of that in net terms) at end-2007. However, the depreciation of the króna, the slowdown in economic activity and the (limited) bank recapitalization during 2008 is projected to push the public external debt-to-GDP ratio to about 100 percent of GDP by year-end; this ratio would be higher than in all recent exceptional access cases.

Table 3. Debt Ratios in Recent Exceptional Access Arrangements 1/
(percent of GDP)

	Total External Debt	Public External Debt	Debt to IMF
Argentina (2003)	129.0	82.5	12.2
Brazil (2003)	38.6	21.5	5.1
Turkey (2005)	35.0	17.8	3.0
Uruguay (2005)	82.0	60.8	13.8
Georgia (2008) 2/	34.6	21.0	2.8
Hungary (2008) 3/	106.4	37.6	4.2
Ukraine (2008) 4/	54.3	10.4	2.5
Iceland (2008) 5/	*165.0*	*99.9*	*5.1*

Sources: Board documents and IMF staff estimates.

1/ Ratios for the year indicated in parenthesis. Year in parenthesis corresponds to the year of approval of the last IMF arrangement with each country.
2/ End-2008 projection, including PRGF resources.
3/ End-2008 projection, see EBS/08/119, Sup. 1 (11/04/08).
4/ End-2008 projection, see EBS/08/114, Sup. 2 (11/03/08).
5/ End-2008 projection, assuming first drawing under proposed SBA. Estimate excludes US$84.8 billion (505 percent of GDP) of banks' external debt (see Table 2).

II. The New SBA—Risks and Impact on the Fund's Finances

6. **If the proposed program is drawn in full, Iceland's outstanding use of Fund resources would exceed the cumulative access limit until May 2014**. Iceland's outstanding use of the Fund's GRA resources would peak at 1,190 percent of quota in October 2010, and remain at this level through January 2012 (Table 4).[6] In terms of quota, this peak borrowing

[6] The figures on debt service to the Fund used in this report correspond to the schedule on an obligation basis, in line with the guidelines stipulated in *Review of Fund Facilities—Proposed Decisions and Implementation Guidelines* (EBS/00/216, 11/3/00). Under the obligations schedule, the first repurchase should take place in February 2012, 3¼ years after the first purchase under the arrangement. Under the policy of time-based repurchase expectations there is an expectation that repurchases in the credit tranches and the EFF, including under exceptional access will adhere to the expectations schedule; an extension from the expectations to the obligations schedule would require a decision by the Executive Board.

would be significantly higher than in recent exceptional access cases, with the exception of Turkey (Figure 2).[7]

7. **In addition, Iceland would face large repayments to the Fund.** The projected repayment to the Fund under the proposed SBA would average SDR 464 million (8½ percent of exports of goods and services) in 2012–14. The resolution of the banks' external debt is another source of risk for debt repayment to the Fund. If, in the end, the government were to absorb an additional fraction of the external debt liabilities of the "old banks," Iceland might have difficulties repaying the Fund and attaining external debt sustainability.

Table 4. Iceland: Purchases and Repurchases under the Proposed SBA, 2008–2015
(in millions of SDRs)

Year	Type of Arrangement	Date of Arrangement	Amount Approved	Purchases	Repurchases 1/	Fund Exposure 2/
2008	SBA	19-Nov-2008	1,400.0	560.0	--	560.0
2009				420.0	--	980.0
2010				420.0	--	1,400.0
2011				--	--	1,400.0
2012				--	358.8	1,041.3
2013				--	568.8	472.5
2014				--	341.3	131.3
2015				--	131.3	0.0

Source: Finance Department.

1/ Following obligations schedule.
2/ As of end-December.

8. **Iceland may become the fourth largest user of Fund resources.** The Executive Board has recently approved two exceptional access arrangements (Hungary and Ukraine). If the proposed arrangement for Iceland is approved, Iceland's share of Fund credit outstanding would be 3.6 percent, considerably lower than the other two cases, but more than three times that of Georgia (Table 5).

[7] Given the large size and front-loaded phasing of the arrangement, surcharges would apply after the first purchase upon approval. Specifically, Iceland would have to pay surcharges of 200 basis points (over the adjusted rate of charge) on all amounts in excess of 300 percent of quota (SDR 207.2 million in the first purchase) and of 100 basis points on the segment of credit outstanding between 200 and 300 percent of quota. Surcharges would cease to apply after August 2014, one year prior to the full repayment of the arrangement, according to the obligations schedule.

Table 5. Fund GRA Exposure

		In Percent of			
				Total GRA Credit	
	SDR Millions	Quota	GDP 3/	As of end-Sep. 2008	After approval of arrangements in panel B 4/
A. Top five borrowers as of end-September 2008:					
Turkey 1/	5,898.7	495.1	1.2	77.9	38.4
Dominican Republic 1/	350.2	160.0	1.2	4.6	2.3
Liberia 1/	342.8	265.3	59.4	4.5	2.2
Sudan 1/	220.9	130.2	0.6	2.9	1.4
Georgia 1/	161.7	107.6	2.0	2.1	1.1
B. Proposed and newly approved exceptional access arrangements:					
Hungary 2/	4,215.0	405.9	4.2	…	27.5
Ukraine 2/	3,073.1	224.0	2.6	1.0	20.0
Iceland 2/	*560.0*	*476.2*	*5.1*	…	*3.6*

Sources: Finance Department and IMF staff estimates.

1/ Fund credit outstanding as of September 30, 2008.

2/ Fund credit outstanding after the first purchases of the proposed SBA for Iceland and recently approved SBAs for Ukraine (EBS/08/114) and Hungary (EBS/08/119). For Ukraine, it includes credit outstanding as of end-September 2008.

3/ Staff projections to end-2008.

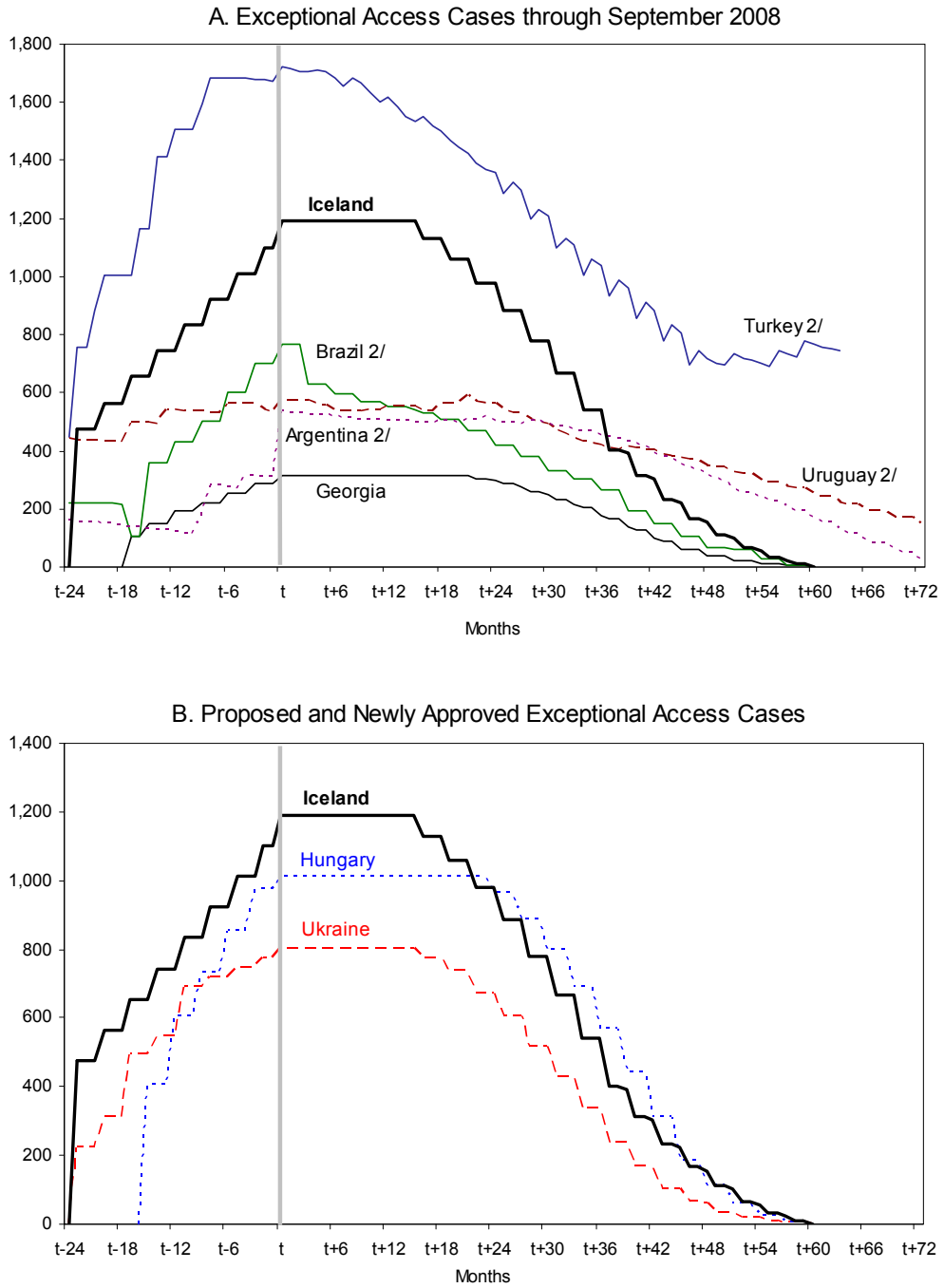
4/ Numerator is Fund credit outstanding as of end-September 2008 for countries in panel A, and Fund credit outstanding as of end-September 2008 plus the first purchases under the proposed and newly approved SBAs for countries in panel B. Denominator is the sum of total Fund GRA credit outstanding as of end-September 2008 and the first purchases of the proposed and newly approved arrangements in panel B.

9. **The proposed SBA will be very large with respect to Iceland's economy.** By end-2008, after the first purchase under the arrangement, Fund credit outstanding will exceed 5 percent of GDP, higher than the comparable ratios for the top Fund borrowers, except Liberia. If the arrangement were fully drawn, the ratio of Fund credit to GDP would be two-to-three times higher than the end-2008 value, depending on the severity of the output decline.[8]

10. **With the proposed SBA, the Fund's share of Iceland's (adjusted) external debt would be significant.** If the SBA is fully drawn, Iceland's outstanding use of Fund resources would account for over 10 percent of external debt by end-2010. In terms of external debt service, Iceland's projected repayments to the Fund would account for close to ¼ of total external debt service during 2012–14 (Table 6); this ratio would be significantly higher than in other recent exceptional access cases.

[8] Using the GDP projections in EBS/08/124, the ratio will reach 16 percent in 2010 (Table 6). Output projections in the proposed arrangement with Iceland, however, are subject to considerable uncertainty.

Figure 2. Fund Credit Outstanding in the GRA Around Peak Borrowing 1/
(in percent of quota)



Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding for a member, in percent of quota. Month t represents the month of the highest historical credit outstanding (in percent of quota). For Argentina, t is September 2001; for Brazil, September 2003; for Turkey, April 2003; and for Uruguay, August 2004. For Georgia, t would be reached in February 2010. For the countries in Panel B, t would be reached in February 2010 in the case of Hungary, and October 2010 in the cases of Iceland and Ukraine. For comparability, projected repurchases are assumed to be on an obligations basis.

2/ Projected repurchases (on an obligation basis) as of May 2005. Schedules do not show large early repurchases made by Argentina, Brazil, and Uruguay in 2005-06.

Table 6. Iceland—Impact on GRA Finances
(in millions of SDRs, at end of period unless otherwise noted)

	2008	2009	2010	2011	2012	2013	2014	2015
Exposure								
Fund GRA credit outstanding to Iceland 1/	560.0	980.0	1,400.0	1,400.0	1,041.3	472.5	131.3	0.0
Fund GRA credit outstanding to Iceland (percent of quota) 1/	476.2	833.3	1,190.5	1,190.5	885.4	401.8	111.6	0.0
Fund GRA credit outstanding to Iceland (percent of total GRA credit outstanding) 2/	3.6	…	…	…	…	…	…	…
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 2/	91.9	…	…	…	…	…	…	…
Liquidity								
One-year Forward Commitment Capacity (FCC) 3/	106,236.4	…	…	…	…	…	…	…
Iceland's impact on FCC 4/	(1,400.0)	…	…	…	…	…	…	…
Prudential measures								
Fund GRA credit outstanding to Iceland (percent of current precautionary balances) 5/	8.1	…	…	…	…	…	…	…
Debt and Debt Service Ratios 6/								
Iceland's GRA credit outstanding (percent of total external debt)	0.8	7.0	10.9	11.2	9.0	4.5	1.4	0.0
Iceland's GRA credit outstanding (percent of GDP)	5.1	11.2	16.0	15.1	10.6	4.5	1.2	0.0
Iceland's GRA credit outstanding (percent of gross international reserves)	15.3	29.8	37.7	37.3	27.5	12.4	3.5	0.0
Iceland's GRA debt service to the Fund (percent of exports of goods and services)	0.1	0.7	1.2	1.5	8.2	11.2	6.3	2.2
Iceland's GRA debt service to the Fund (percent of total external debt service)	0.0	1.1	1.5	2.9	20.8	33.6	18.2	7.9
Memorandum items								
Fund's precautionary balances 5/	6,938.6	…	…	…	…	…	…	…
Fund's residual burden sharing capacity 7/	110.0	…	…	…	…	…	…	…
Projected payment of charges to the Fund on GRA credit outstanding	2.8	35.1	59.0	73.1	66.8	42.8	14.4	2.7
Projected debt service payments to the Fund on GRA credit outstanding	2.8	35.1	59.0	73.1	425.5	611.6	355.7	133.9

Sources: Icelandic authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Repurchases follow the obligations schedule.
2/ Reflects Fund credit outstanding as of September 30, 2008, plus first purchases by Iceland, Ukraine (EBS/08/114), and Hungary (EBS/08/119).
3/ As of November 6, 2008. The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance.
4/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
5/ As of end-April 2008.
6/ Staff projections for total external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA.
7/ Estimated based on end-September data and taking into account the first purchase of Iceland under its proposed program and the first purchases of Ukraine (EBS/08/114) and Hungary (EBS/08/119). Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

11. **Moreover, Iceland's capacity to repay the Fund could be strained further if risks stemming from the resolution of the banking crisis were to materialize, including**:

- **The banks' restructuring strategy may be protracted.** Asset recovery may be hindered by legal actions, or by a more severe global downturn and/or deleveraging.

- **Iceland's return to capital markets may be delayed,** including due to the outcome of the banks' debt resolution. A delayed return to capital markets would imply larger adjustments in the current account and greater fiscal consolidation to meet external obligations.

- **In the near term, further capital outflows could ensue if confidence is not restored quickly.** This could result in further exchange rate depreciation, larger output compression, higher than expected inflation and further deterioration of banks' assets, with attendant negative effects on debt sustainability.

12. **However, given the current high levels of liquidity, the impact of the proposed SBA on the Fund's liquidity position would be modest.** The proposed SBA would reduce the one-year forward commitment capacity (FCC) by SDR 1.4 billion, about 1 percent of the FCC as of November 6—SDR 106.2 billion (Table 6).[9]

13. **The potential GRA exposure to Iceland would also be relatively small in relation to the Fund's precautionary balances.** After the first purchase, outstanding GRA credit to Iceland as a share of the Fund's precautionary balances at end FY08 would be about 8 percent.

14. **Nonetheless, if Iceland were to incur arrears on the charges accruing to its GRA obligations, it would have a considerable but manageable impact on the Fund's burden-sharing capacity.**[10] Charges on Iceland's GRA obligations will be about SDR 35 million

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[9] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of GRA resources available for new financing over the next 12 months. See *The Fund's Liquidity Position—Review and Outlook,* EBS/02/177 (10/15/02); BUFF/02/179 (11/4/02); and BUFF/02/68 (5/15/02). Following the creation of the Short-term Liquidity Facility (SLF), the calculation of the FCC will exclude repurchases falling due under the SLF–see *A New Facility for Market Access Countries—The Short-term Liquidity Facility—Proposed Decision,* SM/08/324, Supplement 1, (10/27/08).

[10] Under the burden-sharing mechanism, the financial consequences for the Fund arising from overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge. The adjustment for the SCA-1 was suspended, effective November 1, 2006, by the Executive Board (Decision No. 13858-(07/1), adopted January 3, 2007).

over the next year, or about one-third of the Fund's estimated residual burden-sharing capacity—taking into account the initial purchases of the arrangements with Hungary, Ukraine and Iceland (Table 6). The Fund's burden sharing capacity, however, would be expected to increase if there is a pick up in lending activity.

III. Assessment

15. **The proposed arrangement for Iceland presents significant financial risks to the Fund.** The main risk relates to Iceland's capacity to repay the Fund, given the very large size of the purchases from the Fund in relation to Iceland's economy and export sector, and the severity of its current financial crisis. The relatively small size of the purchase (in SDR terms) in relation to the Fund's finances, and the strong institutions and track record on macroeconomic policies of the country, mitigates the risks to the Fund.

16. **The large uncertainties surrounding the impact and resolution of Iceland's banking crisis could add significant strains to Iceland's repayment capacity.** In the near term output could be further compressed though balance sheet effects arising from a renewed loss of confidence and further capital outflows and króna depreciation. Over the medium term, while it is possible that asset recovery proceeds faster than envisaged and that the external liabilities of old banks are extinguished in a quick and orderly fashion, the risks are tilted to the downside. In a downside scenario, difficulties in maintaining market access could require further large adjustments in the current account—which should, however, be facilitated by the economy's flexibility demonstrated in previous episodes of sharp adjustment.

17. **Iceland's capacity to repay the Fund hinges on a satisfactory resolution of the banking sector problems and the restoration of confidence in macroeconomic policies and in the regulatory and prudential framework.** This will require quickly adopting strong policies and developing comprehensive bank resolution strategies, and steadfast implementation in the years ahead. Iceland's strong institutions and consensus-based approach to policy formulation would underpin these efforts. In this regard, the authorities' strong resolve to implement the policies contemplated in the proposed SBA provides a key safeguard to Fund resources.